FERC Order 636 Proposed Rule
Analysis Required By
Department of the Interior - Departmental Manual
Part 512 Chapter 2

Recommendation

The proposed rule "Amendments to Transportation Allowance Regulations for Federal and Indian Leases to Specify Allowable Costs and Related Amendments to Gas Valuation Regulations" should be published for comment in the Federal Register. The rule, when adopted as final, will enhance the Department of the Interior's (Department) ability to fulfill its Indian trust responsibility to identify, conserve, and protect Indian mineral resources. Publication of the proposed rule will meet the Minerals Management Service's (MMS) goal of providing certainty, clarity, and consistency on royalty issues.

Background

Current regulations governing the valuation of natural gas for royalty purposes (30 CFR § 206[1] (1995)) allow deductions for the reasonable actual costs of transporting gas from a Federal or Indian lease when the gas is sold at a market away from the lease. These rules establish methods for calculating deductions from royalty value for gas transportation.

Since publication of the current valuation rules, significant changes in the gas transportation industry have occurred, primarily due to regulatory actions taken by the Federal Energy Regulatory Commission (FERC). The FERC initiated these regulatory actions to establish a more competitive gas market in which all shippers could gain access to the pipeline transportation grid. One of the major actions taken by FERC was issuance of FERC Order 636.

Among other changes, FERC Order 636 requires unbundling (separation) of sales and transportation services. Because of this requirement, component costs for gas transportation, which were previously lumped together, are now separated. These components may include transmission, storage, gathering, surcharges for FERC Order 636 transition costs, and administrative charges.

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[1] THE MMS published its current oil and gas valuation regulations in the Federal Register on January 15, 1988 (53 FR 1272).

FERC Tariffs

The FERC tariffs are an integral part of MMS transportation allowance regulations. For arm's-length transportation contracts, MMS allows lessees to deduct the actual costs the lessee is charged under its transportation contract. These contracts are usually based on a published FERC tariff. For non-arm's-length contracts, MMS requires lessees to use the actual costs the lessee incurs to build and maintain a transportation system. However, with MMS approval, a lessee with non-arm's-length transportation costs can use its own FERC tariff to calculate a transportation allowance.

To obtain a FERC tariff for transporting gas through interstate pipelines, companies must go through a comprehensive filing procedure. When writing the 1988 regulations concerning transportation allowances, the MMS concluded that where a lessee has a tariff approved by FERC or a State regulatory agency, it would be unnecessarily burdensome and duplicative to recompute costs. Therefore, MMS recognized FERC tariffs (for both Federal and Indian leases) as a valid cost in computing a transportation allowance when it is an actual (out-of-pocket) expense under an arm's-length transportation contract.

Impact of the Proposed Rule

Prior to implementing FERC Order 636, pipeline companies purchased the gas. The price pipelines offered to sellers generally bundled firm transportation costs together with costs for other component services. With the issuance of FERC Order 636, pipelines can no longer buy and sell gas, they can only provide transportation services, and must break out transportation components for the services they provide. The MMS is proposing a rule to provide payors and auditors guidance on which of these components are allowable for transportation allowance calculation purposes.

Typical costs of the unbundled transportation components are listed below. The proposed rule would allow the first seven components as costs of transportation. The remaining components are necessary for placing the gas in marketable condition or for marketing the gas and are therefore non-allowable deductions.

Allowable Transportation Costs

Firm Demand Charge

Discussion: Shippers that want guaranteed capacity on a pipeline will contract with the pipeline for a capacity entitlement, known as firm transportation. A pipeline generally charges a two-part fee structure for firm transportation: a demand (reservation) charge and a commodity charge. The firm demand charge is designed to recover the pipeline's fixed costs. This charge represents the bulk of the cost to the shipper for transportation.

Average Cost: $0.05-$3.00/MMBtu (Dependent on distance)

The MMS Position: These costs are directly related to the movement of gas and will be allowed as deductions.

Commodity Charge

Discussion: Firm customers pay a commodity charge for the varible costs of pipeline operation (on-line compression, etc.). Interruptible transportation is a lower priority service. During peak demand periods on the pipeline system, interruptible customers' shipping will cease until firm customers' transportation capacity requirements are met. Interuptible customers pay only a commodity charge. This commodity charge is generally derived from the pipeline's fixed costs that are allocated to the service.

Average Cost: $0.01-$0.10/MMBtu

The MMS Position: These costs are directly related to the movement of gas and will be allowed as deductions.

Gas Supply Realignment (GSR)

Discussion: The GSR costs result from a pipeline reforming or terminating supply contracts with purchasers. This occurs due to gas contract settlements or implementing the restructuring requirements of FERC Order 636 or subsequent FERC orders. The States contend that GSR costs should not be an allowable deduction. In a settlement, the pipeline pays the producer for take-or-pay contract violations. The pipeline then passes the cost of these settlements on to all shippers through the GSR charge. The States position is that lessees are adequately compensated for pipelines' take-or-pay violations through the settlement process and that if GSR costs are allowed, the lessee gets the benefit of both the original settlement and the GSR deduction.

Average Cost: Variable (Dependent on volume and value of realignment costs)

The MMS Position: The FERC allows GSR costs in the basic pipeline transportation rates. The GSR charges are levied on every shipper, not just lessees who received settlements. Therefore, MMS considers GSR charges as an actual transportation cost to the lessee. Under existing regulations, MMS allows actual costs. The proposed rule continues this policy by specifically identifying GSR charges as an allowable deduction.

Gas Research Institute (GRI)

Discussion: The FERC allows member pipelines of GRI to charge customers a fee for funding GRI programs. The GRI conducts research, development and commercialization programs on natural gas related topics for the benefit of the U.S. gas industry and gas consumers.

Average Cost: $0.0001-$0.0005/MMBtu

The MMS Position: The MMS has always allowed the GRI fees as part of the transportation allowance and would continue to allow them under the proposed rule.

Annual Charge Adjustment (ACA)

Discussion: The FERC allows pipelines to charge customers an ACA. This fee allows a pipeline to recover its allocated share of FERC's operating expenses.

Average Cost: $0.0001-$0.0005/MMBtu

The MMS Position: The MMS has always allowed the ACA fees as part of the transportation allowance and would continue to allow them under the proposed rule.

Wheeling Charge

Discussion: In many circumstances, gas will be transported through a market center or hub. A hub is a connected manifold of pipelines through which a series of incoming pipelines are interconnected to a series of outgoing pipelines. The hub operator charges a fee for the wheeling, which is transportation of gas from one pipeline through the hub to either the same or another pipeline. Prior to FERC 636, this cost was part of the overall charge levied by the pipeline, but not broken as a separate cost.

Average Cost: $0.01-$0.03/MMBtu

The MMS Position: Wheeling is a service that physically moves the gas from one pipeline segment to another and is directly related to transporting gas. These costs will be allowed as deductions.

<u>Supplemental Transportation Services</u>

Discussion: Pipeline tariffs may contain charges for compression, dehydration, and treatment of gas. Generally, MMS has never allowed the lessee to deduct any costs incurred to place production in marketable condition.

Average Cost: $0.01-$0.05/MMBtu

The MMS Position: Consistent with MMS's current policy of not allowing any costs for placing the production in marketable condition, these costs are generally not allowable. However, if these services are required for transportation, and if they exceed services necessary to place production into marketable condition, MMS may allow some of these costs.

Non-allowable Costs for Placing Gas in Marketable Condition or Marketing

Storage Fees

Discussion: Storage fees cover long-term storage (injection and withdrawal of gas from an underground location) as well as storage of very short duration (often less than one day) which the transporter requires in the course of transporting the gas or for operation of the pipeline. Current regulations state that royalty is due at the time production leaves the lease. If lessees store gas for later sale, MMS requires immediate payment of royalties and does not allow storage fees as a deduction.

Average Cost: Variable

The MMS Position: These costs are nonallowable marketing costs.

Banking/Parking Fees

Discussion: Short duration storage, which often occurs on paper only, is known as "banking" or "parking" and frequently occurs at a marketing center or hub. As discussed above for long term storage, MMS does not recognize any storage fees as allowable deductions.

Average Cost: $0.01-$0.10/MMBtu

The MMS Position: These costs are nonallowable marketing costs.

Aggregator/Marketer Fees

Discussion: Aggregator/marketer fees are fees a producer pays to another person or company (including its affiliates) to market its gas. Aggregator/marketer fees are similar to commissions or fees paid to another party for that party's costs of finding or maintaining a market for the gas production.

Average Cost: $0.01-$0.03/MMBtu

The MMS Position: These costs are nonallowable marketing costs.

Intra-hub Title Transfer Fees

Discussion: In situations where gas is transported through a market center or hub, the hub operator also may assess a fee for administrative services necessary to account for the sale of gas within a hub; e.g., title transfer tracking. Before FERC 636, this was not a cost to the pipeline because pipelines usually bought title to the gas at the wellhead. With unbundling under FERC 636, the pipeline can only provide transportation, so now title must be tracked through all transactions until final sale.

Average Cost: $0.01-$0.03/MMBtu

The MMS Position: These fees are assessed as part of the sales transaction for gas at the hub, not as part of the transportation through the hub. These fees are nonallowable.

Cash-out Penalty

Discussion: Transportation contracts define a specific gas volume that the producer agrees to deliver to the pipeline for shipping. Often, producers over- or under-deliver gas volumes. This is known as an "imbalance". Pipelines establish tolerances, or threshold ranges, for imbalances (usually ± 5 percent). For example, if a lessee/producer delivers volumes greater than the established tolerances, the pipeline will purchase the volumes exceeding the producer's nominated volumes. This is known as "cashing out" the over deliveries to the pipeline. The penalty is usually expressed as a percentage reduction or addition to the cash-out index or reference price. The reduction or addition is minimal for imbalances within the tolerance range, but is more severe for imbalances outside the tolerance range.

Average Cost: 5-25% reduction or increase to cash-out index or reference price

The MMS Position: The MMS views cash-out penalties outside the tolerance ranges as costs incurred as a result of the lessee's breaching its duty to market the production for the mutual benefit of the lessee and lessor. Cash-out penalties are not allowed as a transportation deduction; however, they are considered in determining value.

Scheduling Penalty

Discussion:	Shippers may pay fees or penalties for scheduling when the daily differences in the volume between scheduled and actual pipeline receipts occur; i.e., daily inputs differ from volumes scheduled or nominated at a receipt point and are outside the tolerance specified in the transportation contract or tariff.
Average Cost:	10-40% reduction to reference price

The MMS Position: The MMS views scheduling penalties as costs incurred as a result of the lessee's breaching its duty to market the production for the mutual benefit of the lessee and lessor.

Imbalance Penalty

Discussion: Imbalances which exceed a specified tolerance for over deliveries and under deliveries may be subject to a penalty. When differences in the volume between the pipeline's scheduled deliveries occur outside the tolerance specified in the transportation contract or tariff, shippers pay fees or penalties for imbalances on a daily or monthly basis. (Note: Imbalance penalties and cash-out penalties are not assessed for the same violation.)

Average Cost: 5-10% of reference price applied to imbalance volume

The MMS Position: The MMS views imbalance penalties as costs incurred as a result of the lessee's breaching its duty to market the production for the mutual benefit of the lessee and lessor.

Operational Penalty

Discussion: Operational penalties are fees the shipper pays to the transporter for violation of curtailment or operational flow orders (i.e., orders the pipeline issues to rectify a situation which threatens the integrity of the pipeline.)

Average Cost: $20.00-$35.00/MMBtu

The MMS Position: The MMS views operational penalties as costs incurred as a result of the lessee's breaching its duty to market the production for the mutual benefit of the lessee and lessor.

Discussion

To determine the impact of the proposed rule on Indian royalties, MMS first looked at various tariffs. Our research indicated that tariffs alone did not sufficiently break out the various unbundled cost components. Contact with industry confirmed two beliefs:

1. Most of the unbundled services occur at or downstream of the pipeline interconnect or index pricing point.

2. Transportation agreements between shippers and transporters from the wellhead to the pipeline interconnect have not changed significantly in the post-FERC Order 636 era. Attachments 1a-1c document the receipt and delivery points in a typical transportation agreement. This post-FERC Order 636 agreement does not break out any of the charges discussed above.

Each transportation situation is unique because of distance and area of service. Documentation such as actual transportation contracts, invoices, and/or bills would be necessary to definitively quantify the magnitude of the increased royalties that might result from the proposed rule. At this time, auditors are in the audit cycle preceding the FERC Order 636 changes and we are unable to make a realistic estimate on the proposed rule's impact using actual test cases.

Because we can't use actual test cases, we can't quantify the impact this proposed rule will have on the collection of Indian royalties. If auditors are currently disallowing GSR and wheeling costs, the rule will result in a decrease in royalties collected. If auditors currently accept the rate listed on the tariff transportation rate schedule and continue to do so after publication of the proposed rule, the rule will result in no change in royalties collected. If auditors use the proposed rule to disallow components that were previously allowed, the rule will result in an increase in royalties.

Total Indian gas royalties for Calendar Year 1994 were approximately $42.2M. The total transportation allowances reported to the MMS for the same period were approximately $2.25M. For the same period, the weighted average allowance rate for transportation was $0.28 per Mcf. We know that the $42.2M is less than the actual total royalty value because many payors report net of transportation. The San Juan Basin (Basin) represents about one quarter of the total Indian gas royalties. Analysis for one Tribe in this area identified that approximately 35 percent of the royalties reported did not include a transportation line. Throughout the Basin, transportation deductions are a factor in gas valuation. The analysis indicates that a significant number of payors are not reporting separate lines for transportation, which is acceptable under the current regulations and reporting requirements. Net reporting hinders us from making an accurate estimate of the dollar impact of the proposed rule. The more significant impact, however, is the fact that without guidance, payors will continue to claim all transportation costs thereby negatively impacting Indian royalties.

We tried to evaluate the impact by creating a hypothetical example, as follows.

<u>Example I</u>: Long Line (Beyond Index Point) Transportation

Transportation rate $0.26/MMBtu

<u>Costs</u>

Firm Demand $0.18/MMBtu
Commodity $0.0245/MMBtu
GRI $0.0005/MMBtu
ACA $0.0005/MMBtu
Wheeling $0.0145/MMBtu

Storage	$0.02/MMBtu
Aggregator/Marketer	$0.02/MMBtu
	$0.26/MMBtu

Under MMS' FERC Order 636 proposed rule, allowable costs in this example are:

Firm Demand	$ 0.18
Commodity	0.0245
GRI	0.0005
ACA	0.0005
Wheeling	0.0145
Total	$ 0.22

Nonallowable costs are:

Storage	$ 0.02
Aggregator/Marketer	0.02
Total	$ 0.04

Based on the above example, the proposed rule would result in a $0.04/MMBtu increase in royalties for production subject to this contract if the shipper were claiming the total rate of $0.26/MMBtu as a transportation allowance. In this example, the firm demand charge--clearly allowable under the current or future rules--represents 81 percent of the total tariff rate.

Example II: If we used the highest number from the range for each component; i.e., for firm demand the range is $0.50-$3.00, the relative impact of each category is:

Firm Demand	$ 3.00	74.98%
Commodity	0.10	2.50%
GRI	0.0005	0.01%
ACA	0.0005	0.01%
Wheeling	0.30	7.50%
Storage	0.30	7.50%
Aggregator/Marketing	0.30	7.50%
	$ 4.001	

This example illustrates that even when we use the upper end of the ranges for each component, firm demand remains the major component in the cost of transportation. In fact, in this example, 85 percent of all the charges are allowable costs under current rules and will remain allowable costs under the proposed rule. In the rare instance where the transportation rate included all of these charges, 15 percent would not be allowed under the proposed rule. Without the rule, payors in this scenario would continue to claim the full amount, resulting in a negative impact on Indian royalties.

There has been some discussion of whether this proposed rule is needed at all. If this example were for transportation up to the index point, the issues are not about FERC Order 636 unbundled charges, but what components go into the transportation rate. In the example presented in Attachments 1a-1c, the gathering and treating charge should be dissected into component parts to determine compliance with existing regulations. Some of the $0.24/MMBtu charge is for gathering, compressing, and treating the gas and would not be allowed under our current regulations, even with the rule. A significant issue in the San Juan Basin is the inclusion of transportation and treating costs related to CO_2 removal. Again, this issue is not related to FERC Order 636, but to current policy. Demand charges (the bulk of the transportation tariff) are allowable costs regardless of whether the proposed rule is adopted or not. The rule should have a very small impact on overall royalties paid, but will better enable the auditor to identify the type of costs that would be allowable.

Although the previous examples demonstrate that the monetary impact of the proposed rule is difficult to determine, publication of the rule will have several intangible benefits. First, publication will further MMS's goal of providing clear guidelines to our customers. Second, if cost components are itemized in the various transportation documents, the proposed rule will help auditors identify the nonallowable components. Third, definitive guidance helps the various audit offices consistently apply policy to all payors. Fourth, MMS will benefit from less litigation over these issues. Currently, companies interpret allowable costs to their benefit. When auditors look beyond the FERC tariff to disallow components, no specific regulatory language can be cited as the basis for a finding, therefore many payors appeal these adverse decisions. If an appeal by the lessee is affirmed because of MMS' lack of regulatory authority, potential royalties may go uncollected. The proposed rule will specify which costs are allowable or nonallowable and will result in less appeals due to different interpretations by payors and auditors.

Conclusion

Publication of the proposed rule will meet MMS's goal of providing certainty, clarity, and consistency on royalty issues so that royalties are reported right the first time. We also believe it will reduce litigation costs. With the proposed rule, both royalty payors and auditors will have definitive information on which components are considered allowable or non-allowable. Without the proposed rule, we will continue to see piecemeal application of issues and a high level of litigation. The rule will likely have a neutral or beneficial impact on Indian royalties. Without the rule, payors would claim the full amount of their transportation related costs; with the rule, certain categories are disallowed, and payors would pay additional royalties. We therefore recommend that the proposed rule be published for comment and eventual adoption.